The road to EMU

Bovenberg, A.L.; de Jong, A.H.M.

Published in:
Kyklos

Publication date:
1997

Citation for published version (APA):
Bovenberg, A. L., & de Jong, A. H. M. (1997). The road to EMU. *Kyklos*, *50*(1), 83-109.

KYKLOS, Vol. 50 – 1997 – Fasc. 1, 83 - 109

The Road to Economic and Monetary Union

A.L. Bovenberg and A.H.M. de Jong*

I. INTRODUCTION

The Economic and Monetary Union (EMU) is a project without precedent. Unlike the internal market, EMU will impact EU citizens on a daily basis. Indeed, the common European currency, the *euro*, will affect all financial transactions. Awareness of this is growing now that the euro is planned to be introduced soon. At the same time, according to a recent survey, no less than 78% of European citizens felt badly informed about the EMU project. This has contributed to considerable uncertainty about the consequences of the introduction of the euro. In Germany, where memories of hyper-inflation of the 1920s are still alive, these uncertainties have contributed to outright fear ('Angst') for the euro.

Another uncertainty concerns the group of countries that will introduce the euro in 1999. Only in the spring of 1998 will be decided which EU countries will take part in the EMU from the start. The slowdown of economic growth in the second half of 1995 and the first half of 1996 in the EU has added to this uncertainty because it makes it more difficult for EU countries to meet the convergence criteria for the public finances. This has fueled doubts about whether EMU can actually start on 1 January 1999.

Last but not least, doubts persist about the benefits of EMU. What will Europeans gain from surrendering one of the ultimate symbols of national

* CPB Netherlands Bureau for Economic Policy Analysis, P.O. Box 80510, 2508 GM The Hague, The Netherlands. The authors would like to thank Peter van den Berg, Henk Don, Sylvester Eijffinger, Paul de Grauwe, Alexander Italianer, Gert-Jan Koopman, Ruud Lubbers, Paul Tang and Gerrit Zalm for helpful comments.

sovereignty? According to the survey cited above, about 46% of European citizens remain unconvinced that the costs outweigh the benefits. In Germany, 55% of the population is opposed to EMU. As a direct consequence, the political support seems weaker for EMU than it was for the internal market ten years ago.

This paper surveys various fiscal issues surrounding EMU. Section II describes the current position regarding the preparations for EMU. The costs and benefits of EMU are explored in Section III. Section IV focuses on the transition towards EMU. Why are convergence criteria needed for the public finances? And how will the transition to EMU be managed once it has been decided which countries be admitted to the third phase of EMU? The institutional framework of EMU is surveyed in Section V. How will EMU be managed? What is the role of the excessive deficit rule constraining fiscal policy in the member states? What will be the relationship between the ins – the countries taking part in EMU – and the outs – the EU countries not (yet) taking part? Section VI addresses the impact of EMU on social security and labor markets. The final section contains our conclusions.

II. THE CURRENT POSITION

In December 1995, the European summit in Madrid reaffirmed that EU countries will work towards EMU along the lines of the Maastricht Treaty. At the same time, the European Council took a number of important decisions on the single currency. In particular, the common currency will be called the euro and the third phase of EMU will start on 1 January 1999. The section discusses the path towards a single currency in more detail.

At present, the EU is in Phase 2 of the EMU project. In accordance with the Maastricht Treaty, the European Monetary Institute (EMI) has been installed during this phase. The EMI promotes cooperation between the central banks of the EU countries. Furthermore, it is working on the legal, technical and institutional preparations for Phase 3 of EMU. To illustrate, it develops the monetary instruments of the European Central Bank (ECB) and payment systems. However, national authorities are still responsible for exchange and monetary policy during Phase 2. The member states must make their central banks independent during this phase and carry out programs in order to meet the convergence criteria. Appendix 1 defines the criteria convergence criteria, while Appendix 2 reviews the current position on convergence. The definitions of the convergence criteria reveal that even a 'strict interpretation' of the public finance criteria allows for considerable flexibility.

In the spring of 1998, the European Council will decide which EU member states can start the third phase of EMU[1], on the basis of recommendations from the EMI, the European Commission and Ecofin (the Council of Ministers of Economic Affairs and Finance), and following advance consultation of, among others, the German parliament. The recommendations must be based on the actual outcomes for 1997. Immediately afterwards, the Council will install the ECB. National authorities will remain responsible for monetary and exchange policy during the transitional period up to 1 January 1999, informally known as Phase 2B.

EMU will become operational on 1 January 1999. As of that date, the ECB will be responsible for the monetary policy of the EMU. The central banks of the EMU states will become part of the European System of Central Banks (ESCB). In order to build up critical mass for the euro, all transactions in marketable government bonds, all interbank transactions and all exchange transactions will take place in euros from 1 January 1999. Ecofin will be responsible for agreements with other countries on the exchange rate of the euro[2].

The circulation of euro bank notes and coins will start no later than 1 January 2002. The switch to the single currency must be completed no more than six months later – by 1 July 2002.

The countries that are not admitted to the EMU, the so-called *derogation* countries[3], will not take part in the decisionmaking of the ECB. Every two years the ECB will consider which derogation countries can be admitted on the basis of the convergence criteria set in the Maastricht Treaty (see Appendix 1).

III. WHY EMU?

1. The Benefits of EMU

The most important argument in favor of EMU is that it anchors the internal market more firmly by complementing this market with stable monetary and budgetary policies. In particular, EMU eliminates the economic uncertainty and political tensions stemming from exchange-rate turbulence within the internal

1. On the basis of qualified majority.
2. This applies to the exchange rate of the euro with respect to, for example, the US dollar, the yen, and the currencies of EU countries that are not (yet) part of EMU.
3. Derogation is a legal term for deviation; these of EU countries are also informally referred to as the '*outs*'.

market. Sudden and sharp fluctuations in exchange rates are caused not only by divergent monetary policies, but also by changes in sentiment on financial markets, the so-called *asymmetric financial shocks*. Indeed, the exchange-rate turbulence in 1992 and 1993, and the subsequent decision to widen the fluctuation margins within the ERM, illustrate that free international capital mobility cannot easily be reconciled with exchange-rate stability. As international capital flows within the EU grow further, exchange rates become even more sensitive to changes in sentiments on financial markets. Keeping exchange rates within narrow bounds would thus become increasingly difficult, especially if the prospect of EMU would disappear. In that case, a return to an exchange-rate system with narrow margins would be virtually impossible.

Exchange-rate fluctuations stemming from asymmetric financial shocks may erode political support for both the internal market and disciplined financial policies. In particular, speculative attacks on weak currencies become self-fulfilling if the countries suffering the attacks can avoid depreciations only by sharply raising interest rates. The price of doing so in terms of higher budget deficits (due to more debt service), more unemployment, and a weaker financial sector may well become excessive. A sharp depreciation then becomes inevitable. This feeds the suspicion of EU partners that the depreciating country is abusing its monetary policy as an instrument of trade policy. In this way, political support weakens, not only for disciplined financial policies in the country suffering the speculative attack, but also for the internal market in its EU partners (see also Eichengreen and Ghironi 1995).

In integrated capital markets with flexible exchange rates, financial shocks and divergent monetary policies thus create considerable uncertainty[4]. By eliminating this source of uncertainty, EMU yields lower risk premiums on interest rates, an improved investment climate, lower transaction costs and more confidence in the sustainability of a well-functioning internal market.

EMU encourages countries with a tradition of weak financial discipline to break with this tradition. In a monetary union, these countries can no longer depreciate their own currency to avoid painful choices. By enhancing the credibility of their commitment to financial stability, these countries thus have a great deal to gain from EMU. More financial discipline in these countries benefits also EU partners because financial and monetary stability enhances trade and capital flows.

4. International capital mobility and exchange rate stability can be reconciled only if countries relinquish sovereignty over their own monetary policy. For the trade-off between free capital movements, exchange rate stability and autonomy in monetary policy, see Crockett (1993).

An important political argument in favor of EMU is that it will anchor Germany more firmly in Europe. Without EMU, political tensions may arise between the countries of the Deutschmark bloc and the other EU countries with weaker currencies. Exchange rate fluctuations between the strong and weak EU currencies could fuel these tensions. In particular, other countries may argue that German monetary authorities do not pay sufficient attention to the consequences of German monetary policy for the rest of Europe. After all, the Bundesbank focuses primarily on the situation in Germany. The ECB, in contrast, will consider the situation in all EMU countries when setting its monetary policy.

2. *The Costs of EMU*

EMU yields both transitional and permanent costs. The costs of the transition to EMU involve first of all the physical costs of switching to a new currency. More importantly, considerable uncertainty exists about how the various rules and institutional relationships will operate in practice. Indeed, the various agents have to learn and adjust to the new rules of the game. In the early phase of EMU, the ECB will have to acquire a reputation for disciplined monetary policy. A lack of stable historical relationships (on money demand for example) complicates building up credibility.

Surrendering the exchange rate instrument is one of the permanent costs for the individual EMU countries. These costs are relatively small for countries that currently tie their currencies closely to the Deutschmark, such as the Benelux countries and Austria. Our analysis, therefore, focuses on the EU countries outside the Deutschmark bloc. The costs associated with the loss of the instrument of the exchange rate depends on two factors. First, the importance of country-specific real shocks requiring an adjustment of real exchange rate: the so-called *asymmetric real shocks*[5]. Second, the effectiveness of the nominal exchange rate as an instrument for adjusting the real exchange rate.

With regard to the first factor, many shocks are specific more to a particular industry or region than to a particular country. Indeed, empirical studies show that the production structures of European economies are quite diversified compared to the US economy (see Bofinger 1994). During the early phase of

5. German reunification is an example of such an asymmetrical real shock. The same applies to an economic downturn in the US, which has a particularly negative impact on economic activity in the United Kingdom. In the latter situation, depreciation of sterling against the Deutschmark ensures that real wages in the UK fall enough to avoid a rise in unemployment.

EMU, therefore, asymmetric real shocks are likely to be less important in the EMU than in the US. As economic integration proceeds, business cycles in the EMU countries will become more synchronised, thereby further reducing the frequency of asymmetric real shocks. However, due to scale effects, economic integration could well cause individual countries to become more specialized. This could render asymmetric shocks more sizable and frequent (see Krugman 1993).

The effectiveness of the nominal exchange rate as an instrument to adjust the real exchange rate depends on the functioning of both the labor market and the financial markets. The exchange rate is an instrument for changing real wages without having to adjust nominal wages[6]. However, the more frequently the nominal exchange rate is used as an instrument to adjust real wages, the less effective it becomes because employers and workers see through the effects of nominal exchange-rate movements and discount these in nominal wages and prices. Indeed, in countries with weak monetary discipline, depreciations typically produce higher inflation without improving the competitive position if they are not accompanied by structural measures. The effectiveness of adjustments of the nominal exchange rate depends also on the openness of the economy. The more open the economy is, the more quickly depreciations are transmitted into domestic wages and prices through the effects on import costs, and the less effective the nominal exchange-rate instrument becomes as an instrument to change the real exchange rate[7].

However, the devaluations of the Italian lira in recent years do show that devaluation of the exchange rate can be effective in improving competitiveness by reducing real wages, even in countries with a tradition of weak monetary discipline. This success originated in abolishing the link between wages to prices, the *scala mobile*. However, the Italian experience illustrates also how exchange rate adjustments can threaten the internal market. French businesses

6. Indeed, breaking open nominal wage contracts may impose costs because nominal wage contracts are a way to alleviate the hold-up problem concerning investments in firm-specific capital. Corporatist institutions may substitute for nominal exchange rate flexibility in that they allow nominal wages to adjust to national shocks without breaking open firm-specific contracts, which would threaten long-term firm-specific investments. Accordingly, the loss of the exchange-rate instrument may be most costly for countries that lack these corporatist institutions.
7. The loss of the option to adjust the exchange rate becomes less costly also if EMU leads to the development of alternative mechanisms to adjust real wages to country-specific shocks. For example, nominal wages may become more flexible due to, for example, more effective nation-wide corporatist institutions (see footnote 6). However, these institutions, while alleviating nominal wage rigidity, may produce more real wage rigidity and prevent productivity differentials from being reflected in wage differentiation.

accused the Italians of abusing exchange-rate policy as a 'beggar thy neighbor' policy and even demanded compensation. The French pointed out that the scale of the effective depreciation far exceeded the inflation differentials with other European countries in the preceding years. Indeed, the more successful a depreciation is in improving competitiveness, the more such a depreciation threatens the internal market, especially if changes in exchange rates are sudden and erratic.

The functioning of financial markets is another important factor determining the value of the instrument of the nominal exchange rate. As mentioned above, exchange rates become more sensitive to asymmetric financial shocks as capital becomes more mobile internationally. These financial shocks are often unrelated to the real factors requiring an adjustment of real exchange rates, the so-called *fundamentals*[8].

Especially countries with a tradition of weak monetary discipline that have regularly devaluated in the past are vulnerable to these financial shocks[9]. Therefore, the price of the option to adjust the nominal exchange rate increases as international capital flows grow. This price comprises greater uncertainty about real exchange rates and less transparent prices, which raise transaction costs and discourage potential investors. The greater uncertainties are reflected also in higher real interest rates. For example, Dutch interest rates exceeded German ones for a considerable time after the last devaluation of the Dutch Guilder against the Deutschmark in the early 1980s.

All in all, the costs of surrendering the nominal exchange rate appear to be lowest for the EU countries that have voluntarily linked their currencies to the Deutschmark, and for the EU countries with weak monetary discipline, which are rather vulnerable to changing sentiments on financial markets. The costs are highest for the large EU countries that pursue predictable and credible monetary policies, are more vulnerable to asymmetric real shocks than asymmetric financial shocks, and lack other mechanisms to adjust real wages to shocks. Asymmetric real shocks are more frequent and sizable for countries that are not yet much integrated with the EU and have a rather different production structure and trade orientation than the other EU countries. The United Kingdom is probably the best example of an EU country that faces relatively high costs in surrendering the exchange rate. However, these costs decline as the integration of commodity and financial markets proceeds. The causality runs also the other

8. See, e.g., Meese (1990). Also Bofinger (1994) and Buiter (1995) stress the importance of asymmetric monetary shocks.
9. To illustrate, a weakening dollar or a financial crisis in Latin America tends to put the weaker currencies in the EU under pressure vis-à-vis the Deutschmark.

way around: surrendering the instrument of the nominal exchange rate yields greater wage and price flexibility and stimulates international integration and institutional convergence[10].

3. *Costs Versus Benefits*

In evaluating EMU, we take a slightly more positive view of the benefits than most other reports do because we attach considerable importance to the elimination of asymmetric monetary shocks. This argument is often underrated in other studies[11]. However, hard conclusions based on quantitative research are not yet available. Hence, the overall assessment is rather subjective. Indeed, a monetary union that in principle encompasses the entire EU is an experiment without historical precedent.

The costs and benefits of EMU are not equally distributed among the potential participants. Countries with relatively little monetary and budgetary discipline have the most to gain from EMU. The net benefits are more limited for the countries of the Deutschmark bloc. Germany seems to benefit least because it already pursues credible monetary policies. Moreover, these policies are oriented at the specific needs of the German economy. By giving up its monetary sovereignty, Germany also risks replacing its strong currency by a weaker euro.

These considerations gave Germany an exceptionally strong position in negotiating the specific institutional structure of EMU. Conversely, the countries that could expect the highest net gains were in a weak negotiating position. Therefore, the negotiations on the institutional structure of EMU produced a more equal distribution of the net gains. Germany's main priority in the negotiations was to establish a European currency that would be just as stable as the Deutschmark. To reduce the risks of a weak European currency, Germany insisted that the other EMU member states, with their widely differing monetary

10. At present, the transmission of monetary policy is rather different in the United Kingdom than it is on the European Continent. In particular, short-term interest rates in the United Kingdom exert a much stronger impact on the housing market because of the dominance of short-term and adjustable mortgage contracts. However, the nature of monetary policy in the United Kingdom has contributed to the emergence of these specific institutions on financial markets. Hence, the accession of the UK to the EMU could cause financial-market institutions to converge.

11. Including the European Commission's major report on the costs and benefits of EMU: 'One Market One Money'.

and budgetary traditions, conform to disciplined monetary and budgetary policies.

Another important factor affecting the negotiations on EMU is that Germany's negotiating position is strongest before the European currency is actually established. After all, the political costs for Germany of leaving EMU are higher than that of EMU failing to materialize. These changing negotiating positions can give rise to the so-called *hold-up* problem: the EMU is not established (even though it produces a net gain to all partners) because, in the absence of a political union, Germany is not convinced that its potential EMU partners will not exploit their stronger negotiating position once Germany has surrendered the Deutschmark. Accordingly, Germany has sought assurances from its potential EMU partners that they would keep to the rules agreed upon before the European currency is established. The results of the negotiations are discussed below in the sections on the convergence criteria and the institutional framework of EMU.

IV. THE TRANSITION TO EMU

1. Why Convergence Criteria?

As discussed above, the Maastricht Treaty sets a number of entrance criteria for EMU (see Appendix 1). Especially the convergence criteria for government finances have been heavily criticized (see, e.g., Buiter et al. 1993). They would be arbitrary and inflexible, resulting in undesirable pro-cyclical effects. The result is unnecessary economic damage, which undermines public support for EMU. The criteria may also exclude various EU countries from EMU. By creating two groups within the EU, this might threaten the internal market.

To avoid these problems, a number of economists have advocated a *shock* approach (see, for example, De Grauwe 1992). Countries lacking a tradition of financial stability would be allowed to accede to the EMU without first having to meet the entrance criteria. In this way, they would 'borrow' credibility from countries with a stronger tradition of monetary discipline (such as Germany). The resulting regime switch would allow these countries to reduce inflation and establish financial and monetary stability without having to incur the substantial costs associated with the painful process of gaining credibility themselves. At the same time, the resulting lower interest rates would enable these countries to put their government finances in order. The convergence criteria for the public finances could thus be met, albeit *after* entering EMU instead of *before*.

Why did the Maastricht Treaty opt for a different track: a *gradual* instead of a *sudden* transition, with convergence criteria that have to be met *before* a country can enter EMU – a strategy that makes entrance difficult for precisely those countries that have much to gain from EMU? The main reason is that allowing countries with a tradition of weak financial discipline to enter represents a serious risk for the countries with a strong monetary discipline. In particular, the countries with a tradition of weak financial discipline may be unwilling or unable to live with tight monetary policies that are required to establish price stability within EMU. The institutional rules for EMU, including an independent ECB that has a mandate for establishing price stability, offer no guarantee that the ECB can resist pressures to relax its monetary policies aimed at price stability if such tight monetary policies are perceived to cause serious damage in one or more EMU countries (see also Section V).

The requirement of prior convergence thus reflects both the strong negotiating position and the lack of trust of the EU countries with strong financial discipline vis-à-vis their potential EMU partners. By satisfying the convergence criteria, these latter countries demonstrate their willingness and ability to live by the demands of disciplined financial policies, even if this requires painful choices. Only by providing these signals do these countries convince financial markets and the EMU countries with traditionally tight monetary policies (in particular, Germany) that the euro will be just as strong and stable as the Deutschmark. A convergence period also allows the EMU candidates to adapt their institutions to the financial discipline required by EMU. In this connection, the criteria for the public finances are important, because sound government finances reduce the risk of a serious conflict about the appropriate stance of monetary policy within EMU. Such a conflict would severely damage the credibility of the ECB, particularly during the early stages of EMU, when the ECB has to establish a reputation (see also Section V).

The main problem with the shock approach is, thus, that it fails to recognize that the value of money depends ultimately on confidence in stable financial and monetary policies. Confidence must be earned through the concrete actions needed to meet the convergence criteria. Indeed, these confidence-building measures amount to an investment in the value of the euro.

What about the criticism that the convergence criteria are arbitrary, rigid and prohibitive? The economic profession does not have generally accepted normative theories on optimal debt and deficit ratios, nor on optimal interest and inflation rates. Therefore, from the point of view of economic theory, the convergence criteria are indeed arbitrary. They must be regarded as the outcome of political negotiations, balancing the interests of EU countries with traditionally weak financial discipline with those of EU countries with traditionally strong financial discipline.

Table 1

EMU Convergence Criteria 1991 and 1995

	Percentage price index movements		Long-term interest rate		Public borrowing requirement as % of GDP		Public debt as % of GDP		ERM partici-pation in 1995
	1991	1995	1991	1995	1991	1995	1991	1995	1995
Belgium	3.2	1.5	9.3	7.7	−6.7	−4.4	130.3	133.5 ↓	yes
Denmark	2.4	2.2	9.3	8.5	−2.1	−1.8	64.6	72.0 ↓	yes
Germany	3.6	1.9	8.5	7.0	−3.3	−3.5	41.5	58.1 ↑	yes
Greece	19.6	9.7	...	17.9	−11.4	−2	85.4	111.5 ↑	no
Spain	5.9	4.8	12.4	11.5	−4.9	−6.2	45.8	65.7 ↑	yes
France	3.2	1.7	9.0	7.7	−2.2	−5.0	35.8	52.4 ↑	yes
Ireland	3.2	2.6	9.2	8.4	−2.2	−2.4	96.7	86.3 ↓	yes
Italy	6.4	5.2	13.3	12.4	−10.2	−7.2	−7.2	124.7 ↑	no
Luxembourg	3.1	2.1	8.2	6.1	1.9	0.4	4.1	6.3 –	yes
Netherlands	3.1	2.1	8.7	7.1	−2.9	−3.3	78.8	79.1 ↓	yes
Austria	3.3	2.4	8.6	7.3	−2.4	−6.2	58.7	69.4 ↑	yes
Portugal	11.4	4.3	17.2	11.7	−6.6	−5.1	70.2	70.7 ↑	yes
Finland	4.3	1.2	11.8	9.2	−1.5	−5.6	23.0	59.5 ↑	no
Sweden	9.7	2.9	11.7	10.7	−1.1	−8.1	53.0	79.9 ↑	no
UK	6.8	2.8	10.1	8.3	−2.6	−5.7	35.7	54.0 ↑	no
Average	5.3	3.0	10.6	9.0	−4.3	−5.3	56.0	73.6 ↑	na
Reference value	4.4	3.0	10.7	10.2	−3.0	−3.0	60.0	60.0	

Notes: This table reviews the current positions regarding convergence, based on the information gathered by the EMI for its report 'Progress Towards Conversion', published in November 1995, and the OECD Economic Outlook, June 1996. The arrows show whether the debt ratio rose or fell during the past two years.

For the purposes of the criteria, i.e., to provide signals that countries are willing and able to live with the discipline required by EMU, the arbitrary nature of the criteria does not seem to be a very serious problem. It is important, however, that the criteria are neither too stringent nor too lax – so that all stakeholders in

EMU benefit from EMU. Prohibitively lax criteria, would imply that countries with strong currencies would not be *willing* to enter EMU. Prohibitively stringent criteria, in contrast, would imply that countries with historically weak financial discipline would not be *able* to enter and thus would not be encouraged to improve financial discipline. When the Maastricht Treaty was drafted, the criteria did not seem too stringent. In fact, at that time, eight or nine countries satisfied each of the criteria (see *Table 1*).

The 1992-1993 recession, the growth slowdown of 1995-1996, as well as a low inflation rate reducing nominal growth have complicated the convergence of the public finances. The worsening of the public finances illustrates a major drawback of a drawn-out transition process: the risk that political or economic incidents disrupt the confidence-building process of convergence, thereby creating considerable uncertainty about when and how EMU will actually start. However, the convergence criteria for the public finances allow for considerable flexibility. Indeed, rather than countries meeting certain numerical targets, what ultimately counts is that policy measures succeed in building confidence among the EMU partners that the EMU will function effectively. In this connection, it is worrying that slow convergence in public finances in recent years has not been only a matter of *force majeure*, but has also been due to some countries not seriously pursuing fiscal discipline.

2. *Phase 2B: The Forgotten Transition*

After the selection of the first group of EMU countries in the spring of 1998, the EMU will start only on 1 January 1999. Until that date, the responsibility for monetary and exchange rate policies still formally rests with the national monetary authorities. During this period, considerable exchange unrest may break out – as financial markets speculate on the rates at which currencies will be fixed on 1 January 1999. Indeed, some countries may be tempted not to resist downward pressure on their currencies during this period. During this endgame, these countries can depreciate without losing reputation and without forfeiting entry into EMU (see, e.g., Buiter 1995).

How can exchange volatility and the associated adverse effects on the real economy be contained? The most effective answer would be an 'overnight' transfer of responsibility for monetary policy from the member states to the EMI. In that case, EMU would in fact start several months before the official date of 1 January.

An alternative idea is to gradually narrow the exchange-rate band width of some +/-15% around the central rates. However, as the band narrows, exposure to changes in financial-market sentiment steadily increases. Indeed, narrow bands, free capital flows and internal stability are difficult to reconcile. In particular, countries that do not have the confidence of financial markets may have to sharply raise interest rates to keep their currencies within the band.

Another option is to announce in advance the exchange rates that will apply as of 1 January 1999. This option gives the EMU countries free rein to pursue undisciplined monetary policies in the remaining transitional period. After all, the other member states guarantee the rate of exchange on 1 January 1999. Hence, monetary policy in each country will have to be severely constrained by international agreements. Indeed, whatever option is finally selected, the central banks of the selected EMU countries will have to surrender their autonomous monetary policies long before 1 January 1999.

V. INSTITUTIONAL DESIGN OF EMU

1. The Rules of the Game within EMU

The Maastricht Treaty defines the institutional rules of the game governing the relationships between the various players. In particular, the ECB conducts monetary policy. The Council of Ministers, in this case Ecofin, is responsible for exchange-rate agreements with other countries. Whereas monetary and exchange-rate policy is thus centralized, budgetary policy remains the responsibility of the national states.

The rules of the game are intended to prevent conflicts between the various players, thereby creating the necessary conditions for a stable monetary policy. To ensure that the ECB can achieve price stability, four rules have been developed. First of all, the ECB has an independent position, which in principle is stronger than that of the Bundesbank. The German government can overrule decisions of the Bundesbank. The Council of Ministers lacks this authority. Moreover, on the basis of majority voting, the German parliament can modify the law on the Bundesbank; changing the statutes of the ECB is much more difficult because the parliaments of all EMU members would have to ratify such a change. The second rule protecting the position of the ECB is the *no bail-out* rule, which states that the Bank cannot provide financial assistance to governments that run into fiscal trouble because of budgetary 'misconduct'. The third rule prohibits monetary financing of government deficits. Finally, EMU countries must avoid excessive deficits[12]. If states nevertheless run such deficits, Ecofin can ultimately impose fines.

These rules sparked a great deal of discussion. A first point of criticism concerns democratic control of the ECB. According to the Treaty, the Bank has little accountability to democratic institutions about how it carries out its mandate. This could result in a technocratic image of the ECB, which could ultimately damage the effectiveness of the ECB. Indeed, the ECB can continue to successfully carry out its mandate to establish price stability only if the desirability of stable monetary policies is deeply rooted in society. Making the ECB accountable to the European Parliament, Ecofin, or the European Commission could strengthen the political and public support for disciplined monetary policies (see also, Taylor 1995). In order to strengthen accountability of the ECB, the mission of the ECB to establish price stability could be operationalized further. For example, following the example of the central banks of the United Kingdom and New Zealand, the ECB could pursue a specific inflation objective.

Another major point of discussion involves the excessive deficit rule constraining budgetary policies of the EMU countries. Why don't the rules that give the central bank an autonomous mandate for price stability, that exclude monetary financing and that prohibit bail-outs of governments offer sufficient guarantees for monetary stability? The reason is that countries with historically strong financial discipline do not fully trust countries with weak discipline to comply with the rules agreed before the start of EMU, even after these latter countries have met the convergence criteria. As noted above, the bargaining strength of the countries in the D-mark bloc vis-à-vis the other countries will weaken after the euro has been established. If Germany is not convinced that these other countries are strongly committed to the EMU rules, the hold-up problem prevents the EMU from taking off. The excessive deficit rule is intended to mitigate this hold-up problem by further reducing the risk that the rules will be violated because of a serious conflict between monetary and fiscal policy. To illustrate, despite the rule prohibiting monetary financing, the ECB could come under considerable pressure to stabilize interest rates and the euro exchange rate if a large EMU country would run a sizable fiscal deficit. In this way, the ECB would provide *indirect* monetary financing. In this connection, it should be noted that EMU may actually make lax budgetary policy more attractive by weakening negative feed-back effects on domestic interest rates

12. The definition of excessive deficits corresponds to that of the convergence criteria for the public finances (see Appendix 1).

and exchange rates. This is especially so if the *no bail-out* clause is not credible so that interest rates do not fully capture the additional bankruptcy risk. To illustrate, if a government threatens to go bankrupt, EMU partners may well provide financial assistance, if only because the resulting financial crisis would hurt not only the country concerned but also the other EMU countries due to economic and financial interdependencies[13].

The excessive deficit rule has been severely criticized. In particular, it would afford little scope for absorbing economic shocks. This could increase pressure on the monetary authorities to absorb these shocks through expansionary monetary policies. Furthermore, a rigid excessive deficit rule is difficult to enforce; if an economic setback causes the fiscal deficit of an EMU country to exceed the ceiling of 3% of GDP, Ecofin may not be able to muster the required political support to enforce the ceiling.

All these problems raise the question of whether an EMU with decentralized fiscal policy can be viable. Does the EMU inevitably result in centralization of budgetary policy[14]? Two alternative ways have been developed to reconcile fiscal discipline, which calls for some constraints on decentralized fiscal policy, with maximum flexibility for member states to determine their fiscal policy at a decentralized level.

The first way involves improvements within the framework of the Maastricht Treaty. On the one hand, the excessive deficit rule could become more flexible by requiring that the average deficit over the cycle be lower than a particular value so that the deficit can exceed this ceiling during a recession. On the other hand, the rule could be tightened by lowering the ceiling for the average deficit over the cycle below the Maastricht Treaty criterion of 3% of GDP. A similar line was taken by the German government when it proposed a so-called Stability Pact. It has suggested an average deficit over the cycle of 1% of GDP.

An excessive deficit rule that sets a tight ceiling for the deficit, but adjusts the deficit for the cycle, aims at reconciling, on the one hand, stability (arising from sustainable public finances) and, on the other hand, flexibility to deal with shocks. This yields a number of advantages. By forcing EMU countries to further consolidate their public finances, such a rule creates the fiscal room to have automatic stabilizers work during an economic downturn. These stabilizers could well become more important as a tool to insure countries against

13. Bovenberg et. al. (1991) elaborate on these issues. See also Beetsma and Bovenberg (1995).
14. See, e.g., Feldstein (1992). In the seventies, the MacDougall report on European monetary unification argued in favor of centralized fiscal policy. Also the Bundesbank has argued that EMU would function more effectively in a political union with a center exercising strong controls over fiscal policies of the member states.

country-specific risks if countries can no longer adjust nominal exchange rates to deal with temporary asymmetric real shocks. Moreover, these stabilizers are likely to become more effective, because the excessive deficit rule strengthens the confidence of economic agents that a rising deficit during a recession will not permanently disrupt the public finances. This alleviates the negative direct and indirect (through higher interest rates) feedback effects of expansionary fiscal policy on domestic demand[15].

The additional fiscal room also enables Ecofin to pursue coordinated expansionary fiscal policies in deep recession, thereby reducing pressures on the ECB to relax monetary policy excessively. This would thus yield a better mix of monetary or budgetary policies within EMU. Finally, a more flexible rule would be more likely to be enforced by Ecofin. Hence, it would be more credible. Ultimately, in the absence of full political union, the credibility of the enforcement depends on confidence in a shared preference for monetary and budgetary stability.

The alternative route for decentralized fiscal policy is to change national institutions, which would be allowed to flexibly respond to special circumstances. Eichengreen and Von Hagen (1995), for example, propose that a *fiscal constitution* would lay down the budgetary procedures of the EMU countries. In analogy of an independent central bank, a politically independent *debt board* would annually set a binding ceiling for public debt at the national level.

How do we assess these two alternative proposals for national fiscal policies in EMU? Three points are important here. First, compared to the proposals along the lines of the Stability Pact, national debt boards more severely restrict the fundamental powers of the national Parliaments.

Second, the conflict between rules (which would be inflexible) and institutions (which would allow for flexible responses) should not be overstated. Ultimately, institutions embody rules. Indeed, just as the Stability Pact, debt boards employ rules in order to define what sound fiscal policy actually involves. Moreover, the rules imposed by the Stability Pact strengthen the domestic political position of the Ministers of Finance, which most likely will affect domestic institutions. Accordingly, centrally imposed rules contribute to changes in national institutions.

Third, the fiscal constitution places more confidence in national debt management than the Stability Pact does. How much confidence do the countries with a history of financial stability have in the 'independent' debt management

15. In a monetary union, negative feedback effects on nominal exchange rates vis-à-vis EMU partners would be completely absent.

of EU countries with a weak tradition of monetary and fiscal discipline? As long as doubts remain in this respect, tight centrally imposed rules will be needed. The need for these rules will decrease as concrete actions build up mutual trust and as institutions adapt to the discipline required by EMU. Eventually, the rules should be internalized. However, this point has not yet been reached.

To further build up confidence in each other's fiscal institutions, the transparency of the fiscal policy processes in the EMU countries should be enhanced. This could be done by delegating to an independent institution the measurement and assessment of fiscal imbalances and public debts.

2. *The Relationship Between the 'ins' and the 'outs'*

The EMU is one of the first examples of *variable geometry* in the EU. Some EU countries, the *ins*, take part in EMU immediately, while others, the *outs*, cannot or choose not to take part. The relationship between the ins and the outs is of major importance in preventing the EMU from strengthening the division between, on the one hand, countries with a tradition of strong financial discipline and, on the other hand, the other EU countries. In particular, financial markets could force the outs to raise their interest rates to offset the risk of depreciation against the euro. The expectation of depreciation can become self-fulfilling if the required higher interest rates erode public support for a disciplined monetary and budgetary policy by adversely affecting employment and worsening fiscal imbalances by raising debt service. This scenario implies a serious threat to the internal market, as the exchange-rate volatility feeds protectionist sentiments. Moreover, a financial crisis in a non-EMU country could have serious adverse spillover effects on the EMU countries, just as the recent crisis in Mexico negatively affected the United States. Finally, the ECB may come under pressure to relax its monetary policy in order to avoid a sharp appreciation of the euro versus the weak currencies of the outs.

Both the ins and the outs have an interest in preventing such a scenario. The major question is how. In particular, how much help should the ins provide the outs in preventing a downward slide of the currencies of the outs? The primary support the ins offer is the prospect of admission to EMU. According to the Maastricht Treaty, the outs can join when they satisfy the convergence criteria. The combination of these criteria and the magnetic effect of the EMU strongly encourage the outs to pursue disciplined financial policies.

The ins could provide additional support to the currencies of the outs, for example through interventions or changes in interest rates. In this connection, they must trade-off two risks. Too many commitments on behalf of the outs could jeopardize price stability within the EMU and complicate the task of the ECB to build up a credible commitment to price stability. This risk would be particularly serious if the support of the ins would enable the outs to meet the convergence criteria without adapting their institutions to the requirements of the EMU, or without demonstrating, through concrete action, that they can live with the discipline of EMU. Conversely, leaving the outs to fend for themselves could yield self-fulfilling exchange-rate unrest, thereby threatening the internal market. Central bankers tend to weigh the first risk (i.e., internal instability) more heavily, especially if they doubt that the outs are willing and able to live with the discipline required by the EMU. Employers and workers, who have a strong interest in the internal market, attach a higher weight to the second risk (i.e., external instability), particularly if they believe that the outs need external help in order to establish a regime switch towards more financial discipline. The trade-off between these two risks has played an important role in the concrete proposals that have been put forward on the relationships between the ins and the outs.

Most proposals involve a new exchange-rate mechanism, an ERM-II. Whereas ERM-I featured a symmetric intervention commitment, ERM-II will probably be more asymmetric, due to the substantial importance of the euro and the desire (and power) of the ins to protect the commitment of the ECB to price stability. Accordingly, the outs will have to adjust to the ins, rather than the other way around. With a limited intervention commitment on the part of the ECB, outs may have to substantially move their domestic interest rates in order to prevent changing sentiments on financial markets from yielding substantial exchange-rate movements. These changes in interest rates threaten the internal stability of the outs. Accordingly, the countries with currencies that are most sensitive to changing sentiments prefer rather wide fluctuation bands for their exchange rates. The same holds true for countries, such as the United Kingdom, that do not want to join the EMU because they value their monetary sovereignty. The price of more monetary sovereignty involves potential tensions within the internal market due to exchange-rate volatility.

Each out may feature a different relationship versus the ins. The outs hold different views on the trade-off between independent monetary policy aimed at internal objectives versus exchange-rate stability vis-à-vis the euro. Moreover, for each of the non-EMU currencies, the ins will take a different view on the trade-offs between the risks of internal and external instability. To illustrate, as the outs come closer to meeting the convergence criteria and hence sharing the credibility of the ECB, the risks to internal stability in the EMU of commitments versus these outs decline.

Gros (1990) and Thygesen (1995) recently suggested that the outs would fully comply with the EMU monetary policy by becoming associate members of the EMU. As long as the outs would not meet the convergence criteria, they would not have the rights to vote in the ECB. This proposal is designed to allow the outs to share in the credibility of the commitment to price stability of the ECB. The resulting lower interest rates enable the outs to more easily satisfy the fiscal convergence criteria, thereby allowing them to join the EMU earlier.

Also this proposal, however, cannot escape the trade-off between internal and external stability facing the EMU countries. In particular, this proposal implies a risk to the commitment to price stability of the ECB. As long as different currencies exist, the link between the currencies of the ins and outs can never be fully credible. Indeed, to enhance the credibility of the link, Gros and Thygesen recommend that the ECB and Ecofin issue certain assurances and policy statements. Hence, if financial markets doubt the commitment of the outs to link their currencies to the euro, the ECB may come under considerable pressure to intervene or reduce interest rates to help the outs to sustain their commitment to comply with monetary policy in EMU. Indeed, commitments to the outs imply a risk for the reputation of the ECB and the euro, particularly during the beginning phase of the EMU when the ECB still has to earn its reputation. Accordingly, the financial markets would most likely view associate membership of a country that has not yet met the convergence criteria as a risk factor within EMU.

VI. THE SOCIAL CONSEQUENCES OF EMU

The social consequences of EMU involve the effects of the convergence programs on social security and, through potential negative demand effects, on employment. This section discusses the consequences first for social security and then for employment –both in the short run and the long run. Finally, the pros and cons of an EMU criterion for employment are explored.

Governments link EMU to social security when they point to the EMU criteria to convince public opinion that social security needs to be reformed. However, several studies have shown that sooner or later social security reform is called for – independently of EMU (see, for example, OECD 1987, OECD 1994, and CPB 1992). In some countries, the convergence criteria act primarily as a catalyst for reform so that the required adjustments occur sooner rather than later. In any case, the convergence criteria allow countries considerable discretion on how to establish sound public finances. The selection of specific measures should be based on an analysis of the particular situation in the individual EU countries.

Governments face a dual challenge in making a case for, first, the EMU and, second, specific policy measures aimed at reducing fiscal imbalances. The extent to which they succeed in meeting this challenge constitutes an important test case for EMU. To illustrate, the French government convincing French public opinion that social security should be reformed builds up the confidence of EMU partners (Germany in particular), that France is prepared to live with the discipline that stable financial policies demand.

Most EU countries currently pursue restrictive fiscal policies in order to meet the convergence criteria for the public finances. How should we assess the effects of these policies on aggregate demand and employment? First, since adjustments are unavoidable, the potential adverse negative effects on demand are a question of timing. The EMU criteria encourage countries to bite the bullet of the required fiscal consolidation at an early stage. Moreover, recent experiences in Denmark and Ireland reveal that reducing fiscal imbalances does not necessarily reduce overall demand. The reason is that confidence effects and a lower risk premium on interest rates boost consumption and investment demand, thereby offsetting the direct negative demand effects of budgetary consolidation. These positive offsetting effects are likely to be substantial if fiscal adjustments are perceived to be structural, thereby creating confidence that government finances will be put in order (see, e.g., Alesina and Perotti 1995). Lower nominal interest rates also contribute to cutting fiscal imbalances in countries suffering from high public debt.

Nevertheless, a number of EU countries simultaneously cutting their deficits in an economic downturn does risk a temporary loss in aggregate demand. In such a situation, countries must trade off two risks. Too little fiscal consolidation undermines confidence in EMU. Too much consolidation, in contrast, undermines confidence in an upturn of the business cycle. This trade-off between credibility and flexibility is part of the transitional costs of EMU. Once EMU has functioned effectively for a couple of years and the ECB has earned a credible reputation for price stability, policymakers will find that credibility and flexibility are more easily reconciled.

In the longer run, an effectively functioning EMU helps to create the necessary conditions for sustainable growth and low levels of unemployment by reducing interest rates, mitigating uncertainty and anchoring the internal market. Coordination at the EU level can in principle address potential adverse social effects arising from more intense policy competition. By building mutual trust, a successful EMU project could well create the political basis for such coordination.

EMU affects also labor-market institutions in the member states. In particular, giving up the exchange-rate instrument provides a stimulus for nominal wages to become more flexible and for countries to develop instruments and institutions to replace the nominal exchange rate as an instrument to deal with country-specific shocks. More flexible labor markets, which can be the result of either more competition or more coordination, can help to cut unemployment[16].

However, EMU is no panacea for European structural unemployment. This unemployment problem should be addressed primarily through structural measures involving the labor market and markets for goods and services. Central coordination of these measures is not desirable in view of the country-specific nature of the required structural measures and the diverging preferences and insights regarding the instruments to be used. Nevertheless, the EU may play a useful role in exchanging information. Moreover, coordination and consultation of employers' organizations and trade unions may be useful if the EMU is hit by major union-wide shocks. However, to avoid unemployment in lagging areas, coordination should not result in converging wage levels that are not warranted by convergence in productivity.

Some have argued that the excessive deficit rule should be complemented by a criterium involving unemployment. Indeed, public support for EMU is likely to grow if European countries succeed in substantially reducing unemployment. Moreover, just as a deficit in the public finances, an *employment deficit* due to poorly functioning labor markets can endanger disciplined monetary policies within EMU. In particular, high unemployment increases the temptation to use expansionary monetary policy as a means to temporarily boost unemployment. This could give rise to a major conflict about the appropriate stance of monetary policy, thereby threatening the credibility of the commitment of the ECB to price stability. This illustrates how the creation of EMU gives the participating countries a larger stake in the effective functioning of each other's institutions. Indeed, by sharing the same money, EMU partners become stakeholders in each other's economies.

Whereas these arguments would seem to call for a criterion involving labor markets in addition to the excessive deficits rule, such a criterion rule is difficult to define in practice. There is much less consensus on what good labor-market policy involves than on what constitutes disciplined fiscal policy. Moreover, unambiguous, uniform criteria are difficult to determine because diverging

16. For other effects of EMU on the functioning of labor markets, see Peters (1995).

preferences and institutions across countries call for a country-specific approach.

VII. CONCLUSIONS

EMU is designed to reconcile exchange-rate stability with price stability in an internal market with free capital mobility. Greater financial stability within the EU creates the necessary conditions for sustainable economic growth and high levels of employment. The southern European countries benefit the most from disciplined monetary policies; nominal interest rates in these countries could fall by as much as several percentage points. The Deutschmark bloc benefits from less erratic exchange-rate movements vis-à-vis the EU partners. Most importantly, by eliminating the political tensions that are associated with exchange-rate movements within the EU, EMU anchors the internal market.

The benefits of EMU assume that monetary policy within EMU is aimed at price stability. However, in view of the diverging monetary traditions in the potential EMU countries, this cannot be taken for granted. Indeed, by sharing monetary sovereignty with countries featuring a different tradition, the countries with a tradition of financial stability face the risk that they will replace their strong currencies with a weak euro. In this connection, we stressed the role of confidence because the (internal and external) value of money ultimately depends on confidence. In particular, the value of the euro depends on the confidence

- of the EMU countries in each other as partners: that they see eye-to-eye on the need for disciplined financial policies and that their political and economic institutions can cope with the discipline required by EMU;
- of the EMU countries and financial markets that the rules of the game laid down in the Maastricht Treaty can be enforced so that the EMU institutions can function properly;
- of the financial markets and European citizens that the euro will be a stable currency;
- of the derogation countries and the financial markets, that the derogation countries will continue to pursue disciplined financial policies and will be able to eventually enter EMU;
- of public opinion and business community that the EMU project helps to ensure rapid growth and high employment.

At the time the Maastricht Treaty was drafted, the countries of the D-mark block regarded the risks of instantaneously pooling their monetary policies with their EU partners as too high. In other words, confidence was lacking for a *shock* approach to EMU. Instead, the Maastricht Treaty intended to gradually build up the required confidence during a period of convergence. During this period, countries would take concrete measures to strengthen mutual trust and confidence of European citizens and financial markets in the EMU project. Indeed, confidence does not develop automatically: it must be earned through concrete actions.

After establishing convergence through such actions, EMU could start. In order to prevent Germany from further holding up EMU, the EMU would function with a number of centrally imposed rules of the game enhancing the credibility of the commitment of the ECB to price stability. Indeed, several of these rules were designed to mitigate the hold-up problem.

The strategy to earn the confidence of European citizens and the financial markets in EMU has succeeded only in part. Also the recent slow down in growth has undermined confidence in the feasibility of EMU. A vicious circle of lack of confidence and slow growth threatens EMU; slow growth causes countries to fail the convergence criteria. This erodes confidence and increases the uncertainty surrounding EMU, thereby harming growth further. Ultimately, EU countries could be faced with the choice of delaying EMU or allowing EMU to go ahead on a rocky basis.

Fortunately, EMU countries still have ample opportunities to strengthen confidence in EMU by properly designing Phase 2B, the relationship between the ins and the outs, and the Stability Pact. Indeed, further strengthening the credibility of the commitment of price stability of the ECB by improving the institutional framework for EMU alleviates the hold-up problem so that EMU will not have to be delayed. For example, more transparent fiscal accounting may help build confidence among EMU partners and allow financial markets to better discipline governments. Also a credible employment strategy and a successful Intergovernmental Conference help strengthen public support for and confidence in EMU.

Despite all ex-ante analysis, all major European projects, including the internal market and EMU, remain a leap in the unknown. The rules laid down in the Maastricht Treaty do help to reduce the serious risks. However, treaties cannot offer a watertight guarantee that EMU will indeed function as envisaged. Ultimately, the quality of the European institutions that safeguard financial stability depends on the values held by European citizens. Therefore, public support for a common monetary policy aimed at price stability is crucial. In this connection, the survey results mentioned in the introduction are disturbing. Economists and politicians have still important work to do in convincing the European citizens that EMU is a risk worth taking.

APPENDIX 1

What are the Convergence Criteria?

The EU member states must satisfy five convergence criteria before they can participate in the third phase of EMU. These criteria involve inflation, long-term interest rates, the public- sector borrowing requirement (the 'EMU deficit') and the gross public sector debt ratio; the EU member states must also have participated in the exchange-rate mechanism (ERM) of the European Monetary System (EMS) for at least two years.

The specific criteria are as follows. The rate of inflation may not exceed the average increase in consumer prices in the three member states with the lowest inflation rates by more than 1%- points. A similar criterion applies to long-term interest rates: interest rates on long-term government bonds must not be more than two percentage points higher than the rates in the three countries with the lowest inflation rates. The borrowing requirement of the public sector may not exceed 3% of GDP, unless it is falling substantially and continuously and lies close to the reference value of 3%, or unless the excess borrowing is exceptional, temporary, and small. The gross debt ratio of the public sector must either be below 60% of GDP or be declining towards the 60% norm at a satisfactory rate. Finally, the exchange rate must have stayed within the 'normal' ERM band for at least the last two years: When the Maastricht Treaty was signed, the normal band width involved a margin of 2% (in a few exceptional cases it was 6%) above and below the central rate. Since the exchange-rate tensions of August 1993, the band width widened to 15% above and below the central rate.

These definitions reveal that even a 'strict interpretation' of the criteria allows for considerable flexibility. This holds in particular for the criteria on the public finances. Moreover, when the Maastricht Treaty was signed in 1991, these criteria did not appear exceptionally demanding. At that time, eight or nine countries satisfied the norm set by each criterion; see also *Table 1*.

APPENDIX 2

The Current Convergence Position[17]

The EMI concludes that, on the basis of economic trends in 1994 and 1995, convergence was not sufficient. When the EMI report was published, only

17. Information taken from the EMI report 'Progress towards Convergence', Frankfurt, November 1995 and OECD Economic Outlook, Paris June 1996.

Germany, Ireland and Luxembourg satisfied the convergence criteria (the German borrowing requirement in 1995 has since then proved to exceed 3% of GDP). All other countries featured an 'excessive' deficit because they failed to satisfy the criteria for the borrowing requirement and/or the debt ratio of the public sector. The picture regarding inflation and interest rates was much brighter. At the end of 1995, eleven countries met the inflation criterion and ten satisfied the interest rate criterion.

The EMI does not judge the exchange-rate criterion. However, five countries (Greece, Finland, Italy, the UK and Sweden) did not participate in the ERM in 1995, while the central rates for Spain and Portugal were decreased in March 1995.

Early 1995, public finances in EU countries were projected to improve substantially in 1997. On this basis, eight to ten countries could in principle have taken part in EMU: Ireland, the original six EC members, excluding Italy, probably also Finland and Sweden, and possibly Denmark and the UK (although the latter two countries can decide to opt out).

The sharp slow down in EU growth in the second half of 1995 and the first half of 1996 has made this outcome very uncertain for France and Germany. On the basis of a fairly strict interpretation of the criteria and the current forecasts, only a few countries will satisfy the convergence criteria without substantial additional policy measures.

REFERENCES

Alesina, A. and R. Perotti (1995). Fiscal Expansions and Adjustments in OECD Countries, *Economic Policy*. October: 205-248.

Beetsma, R.M.W.J. and A.L. Bovenberg (1995). Does Monetary Unification Lead to Excessive Debt Accumulation?, *CEPR Discussion Paper* No. 1299, London.

Bofinger, P. (1994). Is Europe an Optimum Currency Area? *CEPR Discussion Paper* No. 915, London.

Bovenberg, A.L., J.J.M. Kremers and P.R. Masson (1991). Economic and Monetary Union in Europe and Constraints on National Budgetary Policies, *IMF Staff Papers*. 38, 2: 374-398.

Buiter, W.H. (1995). Macroeconomic Policy During a Transition to Monetary Union, *CEPR Discussion Paper* No. 1222, London.

Buiter, W.H., G. Corsetti and N. Roubini (1993). Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht, *Economic Policy*. 16: 57-100.

CPB. *Nederland in Drievoud* (The Netherlands in Triplo). The Hague: Sdu Publishers, 1992.

Crockett, A. (1993). Monetary Policy Implications of Increased Capital Flows, in: Jackson Hole (ed.), *Changing Capital Markets: Implications for Monetary Policy*. Wyoming: The Federal Reserve Bank of Kansas City.

Eichengreen, B. and J. von Hagen (1995). *Fiscal Restrictions and Monetary Union; Rationales, Repercussions, Reform*, paper presented to the Economic Policy Forum, University of Saarbrücken, October.

Eichengreen, B. and F. Ghironi (1995). European Monetary Unification: The Challenges Ahead, *CEPR Discussion Paper* No. 1217, London.

Feldstein, M. (1992). The Case Against EMU, *The Economist*. June 13: 19-22.

Grauwe, P. de (1992). *The Economics of Monetary Integration*. Oxford: Oxford University Press.

Gros, D. (1996). Towards Economic and Monetary Union: Problems and Prospects, Brussels: *CEPS Paper* No. 65.

Krugman, P. (1993). Lessons of Massachusetts for EMU, in: F. Torres and F. Giavazzi (eds.), *Adjusted and Growth in the European Monetary Union*. Cambridge: Cambridge University Press.

Leibfritz, W., D. Roseveare, D. Ford and E. Wurzel (1996). Aging Populations, Pension Systems and Government Budgets, in: *Future Global Capital Shortages*. Paris: OECD.

Meese, R.A. (1990). Currency Fluctuations in the Post-Bretton Woods Era, *Journal of Economic Perspectives*. 4: 117-134.

OECD (1987). *Structural Adjustment and Economic Performance*, Paris: OECD.

OECD (1994). *Jobs Study*, Paris: OECD.

Peters, T. (1995). European Monetary Union and Labour Markets – What to Expect? *International Labour Review*. 3: 315-332.

Taylor, C. (1995). 'EMU 2000?' Prospects for European Monetary Union, Chatham House Papers, London: The Royal Institute of International Affairs.

Thygesen, N. (1995). The Prospects for EMU by 1999, Copenhagen: EPRU Working Paper 95-17.

SUMMARY

This paper discusses various issues involving EMU. In evaluating the potential benefits of EMU, we stress that the elimination of asymmetric financial shocks enhances confidence in the sustainability of a well-functioning internal market. The convergence criteria reflect both the strong negotiating position and the lack of trust of the EU countries with strong financial discipline (and Germany in particular) vis-à-vis their potential EMU partners. Moreover, Germany has sought assurances from its potential EMU partners that they would keep to the rules after the single currency has been established. In this connection, we discuss two alternative ways to reconcile fiscal discipline with flexibility for member states to determine their fiscal policy at a decentralized level. The paper also discusses the relationship between the EU countries taking part in EMU immediately and the other EU countries that cannot or choose not to take part. Finally, we assess how EMU might affect the labor market, social security, and employment.

ZUSAMMENFASSUNG

Dieses Referat behandelt mehrere Themen im Rahmen der Europäischen Währungsunion (EWU). Bei der Evaluation möglicher Vorteile der EWU, heben wir nachdrücklich hervor, daß die Auflösung asymmetrischer finanzieller Schocks, das Vertrauen in einen dauerhaften, gut funktionierenden Binnenmarkt stimuliert. Die Konvergenzkriterien widerspiegeln nicht nur die starke Verhandlungsposition der EU Mitgliedsländer mit einer starken finanziellen Disziplin (und der Bundesrepublik Deutschland insbesondere), sondern auch ihr Vertrauensmangel potentiellen Partnern in der Währungsunion gegenüber. Ausserdem hat sich die BRD vergewissert, daß ihre potentiellen EWU Partner, nachdem die Europäische Einheitswährung eingeführt worden ist, den vorher vereinbarten Abmachungen nachkommen. In diesem Zusammenhang diskutieren wir, wie etatmässige Disziplin, mit der Flexibilität ihre Haushaltspolitik auf dezentraler Ebene zu gestalten, in Einklang gebracht werden kann. Das Referat behandelt auch die Beziehung zwischen EU

Mitgliedsländern, die unverzüglich der EWU beitreten und denjenigen Ländern, die nicht beizutreten vermögen oder beabsichtigen. Letztendlich diskutieren wir die möglichen Auswirkungen der EWU im Bereich des Arbeitsmarktes, der sozialen Sicherheit und der Beschäftigung.

RÉSUMÉ

Cet article traite de questions différentes impliquant l'Union Economique et Monétaire (U.E.M.). Par l'évaluation des bienfaits potentiels de l'U.E.M., nous insistons sur le fait que l'élimination de chocs financiers asymétriques rehausse la confiance dans un marché commun durable faisant preuve d'un bon fonctionnement. Les critères de convergence reflettent à la fois la forte position négociatrice et le manque de confiance des pays de l'Union Européenne avec une forte discipline financière (l'Allemagne en particulier) à l'égard de leurs partenaires potentiels de l'U.E.M. En outre, l'Allemagne s'est assurée auprès de ses partenaires potentiels du respect des accords convenus après l'introduction de la monnaie commune. A ce propos, nous discutons sur la manière dont une discipline budgétaire peut se réconcilier avec la fléxibilité pour des Etats membres à déterminer leur propre politique budgétaire à un niveau décentralisé. L'article traite également de la relation entre les pays de l'Union Européenne prenant part immédiatement à l'U.E.M. et les autres pays de l'Union Européenne qui ne peuvent pas ou préfèrent de ne pas y adhérer. Finalement, nous évaluons comment l'Union Economique et Monétaire pourrait affecter le marché du travail, la sécurité sociale et l'emploi.